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NOTES.

STOCK DIVIDENDS AS TAXABLE INCOME.—A owns a number of shares in a prosperous corporation which has made a large amount of money, but as yet the directors have not seen fit to distribute it among the shareholders. If A knows anything about the affairs of his corporation, he will appreciate fully his advantageous position, and will part with his certificates only for a sum which reflects the value of his share of the accumulated funds. At this point the directors decide that the money can be used for the purposes of the business to good advantage; it may in fact be already invested in permanent improvements so that it cannot

readily be realized for distribution. As a perfectly legitimate operation, new stock is issued equal in par value to the whole or part of the surplus, and distributed *pro rata* in place of cash to the shareholders,—for convenience being called a "stock dividend". A is perfectly satisfied; he is in no need of the cash now, and if he should be later, he knows he can find a ready market for any or all of his holdings. But the income tax collector informs him that he has received an income of, say, \$100 for each of those new shares. "\$100" is printed on the face of the certificate and A certainly would not sell it for less than that sum; "\$100" is also printed on the face of the old certificate and A certainly would not sell that for less than that sum. But the old share would have sold for more than \$200, a month ago. Has A, then, received an income through the issuance of the stock dividend?

In the Federal Income Tax Law of 1913¹ no reference is made to stock dividends, but under § 2A, subd. 2² of the same act, the Treasury Department issued instructions that they were not to be treated as income for purposes of taxation.³ These instructions were subsequently reversed so as to tax the dividends as income for their "cash value".⁴ Such departmental rulings are, of course, merely administrative, for the statute alone determines what is income to be taxed.⁵ In the recent case of *Towne v. Eisner* (D. C., S. D. N. Y. 1917) 242 Fed. 702, the plaintiff had received stock dividends issued by a corporation out of earnings made previous to March 1, 1913.⁶ The court held that he was liable for the tax on a sum equal to the par value of the new shares. An appeal has been taken to the Supreme Court where the case will be heard in the present term. Two points are involved: whether or not stock dividends are income under the statute; and, if so, are they taxable out of money earned prior to March 1, 1913? This second question is beyond the scope of the present writing.⁷

Stock dividends have been considered many times in cases where a trustee holds the parent shares, and both the life tenant and the

¹38 Stat. 166, c. 16, § 2 A, subd. 1. "there shall be levied * * * upon the entire net income arising or accruing from all sources in the preceding calendar year * * * a tax of one per centum per annum * * *."

²"Every person subject to this additional tax shall * * * make a personal return of his total net income * * * under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury."

³T. D. 2163, February 18, 1915. "Stock dividends issued as a *bona fide* and permanent increase of the capital stock of corporations * * * without intent to evade the imposition of the personal income tax, are held to represent capital; and are not subject therefore to the income tax as gains, profits and income in the hands of stockholders."

⁴T. D. 2274, December 22, 1915. "Stock dividends paid from the net earnings or the established surplus or undivided profits of corporations * * * are held to be the equivalent of cash, and to constitute taxable income under the same conditions as cash dividends."

⁵*Edwards v. Keith* (C. C. A. 1916) 231 Fed. 110.

⁶38 Stat. 168, c. 16, § 2 D. "for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first * * *." The reason for this provision lies in the fact that the Sixteenth Amendment was not signed until February 25, 1913.

⁷This question will be considered in a subsequent number of the Review.

remainderman claim the new shares.⁸ The conclusions arrived at in the different jurisdictions are hopelessly irreconcilable, but it is not at all necessary to take sides in the controversy, because it is plain that the considerations involved in this question are quite different from those involved in the question whether or not the stock is to be taxed as income. Where the earnings are all accumulated during the life tenancy, it may be entirely equitable to give them to the life tenant, but that fact has no bearing at all on the question whether or not they are income for purposes of taxation. This is shown in a most striking manner by the case of *Trefry v. Garfield* (Mass. 1917) 117 N. E. 904 which arose under the Massachusetts Income Tax Law. The court there decided, as in the Towne case, that stock dividends were income for taxation; and this despite the fact that Massachusetts is one of the jurisdictions which hold that, regardless of the source of the earnings, such dividends are not income for the life tenant.⁹ These cases between life tenant and remainderman do, however, aid in the solution of the present problem in so far as the decisions contain analyses of the nature of a stock dividend.¹⁰

If a share of stock or piece of real estate has risen in value but has not been sold, can it be said that the owner has received an income equal to the increase in value? In case of a fall in the realty market or serious reverses in the affairs of the corporation, the owner may never have received a dollar of these "paper profits". It is entirely possible for a man to grow richer without any income. As would be expected, the Treasury Department does not assume to tax this appreciation in value.¹¹ Nor is there any need that they do so, for, ever since the law went into effect, gains made on the resale of capital assets have been subject to the tax.¹² Wherein does the position of the recipient of a stock dividend differ from that of a holder of property which has increased in value? Of course he has received something new from the corporation; but what is the real value of these new pieces of paper? Except for a change in the legal status of the fund, the new shares plus the old shares represent exactly the same thing that the old one did before. Here a tax is being levied on a so-called distribution of earnings when the transaction really

⁸16 L. R. A. 461.

⁹*Minot v. Paine* (1868) 99 Mass. 101; *Gardiner v. Gardiner* (1912) 212 Mass. 508, 99 N. E. 171.

¹⁰*Gibbons v. Mahon* (1890) 136 U. S. 549, 10 Sup. Ct. 1057 is by far the most instructive of these cases, the Court holding that stock dividends are capital rather than income.

¹¹"any appreciation in the value of assets due to appraisal or adjustment and taken up on the books of the individual or corporation is held not to be income within the meaning of the law until such appreciation as a result of a completed, a closed transaction, has been converted into cash or its equivalent, that is, has been realized as an addition to and a part of the tangible assets of the individual or corporation. A book entry reflecting only an enhanced value of assets during the year evidences an increase in the net worth of the corporation or individual for that year, an increase which, under adverse conditions, may disappear the next year. An increase in value thus evidenced is intangible, unstable and is not such income as the federal income tax contemplates shall be returned for purposes of the tax." Letter to Collectors, August 14, 1914. Corporation Trust Company's Income Tax Service § 260.

¹²*Montgomery, Income Tax Procedure for 1917*, at p. 18 *et seq.* This seems to be contrary to the English practice. See 17 *Columbia Law Rev.* 149.

has the effect of putting them where they cannot be distributed. It is true that the share plus its cash dividend represents in value what the share did before, but in such a case a *separation* has taken place between capital and its fruit. That is all that is contended for, a separation. It is not maintained that actual money need be distributed. Where Liberty Bonds were given out instead of cash dividends it was entirely correct to call them income.¹³ And in a case such as *Trefry v. Putnam*,¹⁴ where the court held that money received from the sale of stock rights was taxable income, the separation has been consummated and the stockholder has something else in place of his new share.¹⁵ In waiting for a separation, there is no question of the government being deprived of its revenue; when the owner parts with the shares he is taxed for any gain. If the earnings are reserved by a corporation to defraud the government, ample power is given in the act itself to deal with the situation.¹⁶

In the new Income Tax Law of September 8, 1916¹⁷ and the amendment of October 3, 1917,¹⁸ stock dividends are expressly included under "income". The instant cases, therefore, could not arise in their present form under these statutes. The only question would be one of constitutional interpretation, involving the term "income" as used in the Sixteenth Amendment, and as constitutional wording must in its very nature be general, it would be a narrow view not to allow stock dividends to be taxed as income when expressly named. But in the instant cases, although it is easy to understand why the courts decided as they did since as a practical matter business men would consider stock dividends as so much profit-distribution, yet it is submitted that on closer analysis such dividends are not income, and should not be taxed as such.¹⁹

¹³Decision of Attorney General Gregory, July 27, 1917, Corporation Trust Company's Income Tax Service § 2279. Where a promissory note is received during the year, not however as part of a dividend, it may be correct to include it under income as was directed by Deputy Commissioner Speer in his letter of March 1, 1915, Corporation Trust Company's Income Tax Service § 242, but it might have been better to wait until the money was paid, instead of leaving the promisee to a more or less questionable remedy in the form of a rebate for loss in the subsequent year in case the note should not have been paid.

¹⁴(Mass. 1917) 116 N. E. 904. This case was argued and decided with *Trefry v. Garfield*, *supra*.

¹⁵The same result is obtained under the federal law. Letter from Deputy Commissioner Speer, February 27, 1915, Corporation Trust Company's Income Tax Service § 287.

¹⁶38 Stat. 166, c. 16, § 2 A, subd. 2 provides for the tax on profits withheld for the purpose of evading the tax.

¹⁷39 Stat. 756, c. 463, Title I, Part 1, § 2 (a). "the term 'dividends' as used in this title shall be held to mean any distribution made * * * by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen and payable to its shareholders, whether in cash or in stock of the corporation * * * which stock dividend shall be considered income, to the amount of its cash value."

¹⁸War Revenue Act of October 3, 1917, § 1211 reads: "which stock dividend shall be considered income, to the amount of the earnings or profits so distributed."

¹⁹For a general discussion of the subject, the reader is referred to the excellent chapter on Stock Dividends in Montgomery, *Income Tax Procedure for 1918*.